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FIRST NATIONAL CITY BANK

Monthly Letter

Business and Economic Conditions

New York, March 1961

General Business Conditions

THE question in everyone's mind now is whether the economy is making a bottom or giving any signals of improvement. Certainly the published data offer little encouragement; industrial production slipped another point during January, and new orders for durable goods continued to sag. Unemployment rose to an estimated 5.4 million, of whom 1.3 million were reported out of work for 15 weeks or more. Trade, hurt by an unusual succession of snow storms along the heavily populated Boston-Washington axis, has been depressed and merchants await with more than usual eagerness the arrival of spring to bring better business. Meanwhile, inventory liquidation continues, although there are some spots, as in steel, where the reduction of stocks has gone far enough to require some increase in ordering and production. When that condition becomes more typical — as it should before too many more weeks have passed — the seeds of recovery will have sprouted.

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The Administration, naturally concerned about the business slide, remains hopeful that an upturn will develop in the spring. This expectation is generally held by economists, some of whom, observing the sluggishness of the first quarter, speak of 1961 as the reverse image of 1960 with activity moving up instead of down. In the business community, faced with severe pressure on profit margins, more of a wait-and-see attitude is prevalent. Of particular concern is the posture the new Administration takes on wage demands, taxes, and price increases required to cover added costs. Profits are already in a squeeze — with Treasury tax revenues suffering as a consequence. It should be clear to everyone that increases in employment costs are not a proper formula for prosperity, least of all in a situation where we need to have and hold major markets abroad if we are to provide maximum job opportunities.

Inventory Liquidation Continuing

The Federal Reserve Board's index of industrial production (1957=100, seasonally adjusted) slipped off another point to 102 in January, making an 8.0 per cent decline from the record peak in January 1960. So far, at least, the downturn has not, in terms of industrial production, reached the dimensions of the three preceding recessions: 10.0 per cent in 1948-49, 10.2 per cent in 1953-54, and 14.5 per cent in 1957-58.

In the early months, the decline this time was concentrated in durable goods, where intense levels of activity had been reached in the opening weeks of 1960 to make up for lost production during the steel strike. Activity in the production of nondurable goods did not reach its peak until June. In recent months, practically all categories of manufacturing have been cut back.

Excessive inventories became a matter of serious concern in the business community in the second quarter of 1960. Manufacturers gradually cut back operations to match the disappoint-

ing inflow of new orders and to check inventory accumulation and accomplish reductions. However, it was not until the final quarter of the year that substantial reduction in stocks was achieved. Continuation of this same process of inventory liquidation is a major factor in the decline in industrial activity in the initial months of 1961.

The steel industry, with the disappearance of fears of price advances, was the first to feel the impact of cautious buying policies. It is encouraging now to note a small but definite improvement in the inflow of steel orders which suggests that steel, at least, has turned a corner. Steel ingot production during February ran at an estimated daily average of 221,300 tons (equivalent to 80.8 million tons a year), up 17 per cent from the 188,400 tons daily production in December (equivalent to 68.8 million tons a year).

In the automobile industry, there is a contrasting picture. Retail sales of new passenger cars got off to a slow start. Deliveries over the first seven weeks of the year were down 23 per cent from the corresponding period a year ago and were only a shade above 1958 when retail sales of domestic passenger cars touched the lowest levels since 1952. In order to hold back inventory accumulation among dealers, the automobile companies curtailed production further in February, though hopes remain that the end of an unusually severe winter will bring many more customers into the showrooms.

On an industry-wide basis, inventory liquidation represents the major factor holding back employment opportunities and the gross national product (GNP). The flattening out of the GNP at an average level of $504 billion since the second quarter of 1960 is accounted for by the inventory factor. Final demand (the GNP less the element of inventory accumulation or liquidation) has continued to push higher. So long as this continues — and final demand is being prodded upwards by increases in government outlays and easier availability of credit — an upturn in general business activity is simply a matter of time. The general experience with postwar business recessions is that a phase of inventory contraction, once started, is apt to last about a year. Nevertheless, there is reasonable hope for business improvement before that, because the level of the GNP can be helped by a mere slowing in rate of inventory liquidation.

Corporate Earnings in 1960

Corporate reports for 1960 reveal the widely divergent experiences of American business in a new and challenging environment in which cost pressures continued to rise while competitive conditions forestalled needed price increases or, in many cases, led to price cuts. Thus, while the nation's economy attained new records in production and sales, most corporations enjoyed little or no improvement in earnings from 1959, when profits were held down by the widespread effects of the prolonged steel strike.

Our tabulation of annual reports issued to date by 2,347 companies shows combined net income of $18.5 billion for 1960, an increase of 2 per cent from the previous year. In manufacturing, earnings declined 2 per cent from 1959 despite the higher sales reported by most companies.

The slight improvement in this compilation largely reflects the influence of two longer-term factors: the continued expansion in revenues of utility companies supplying electric power, telephone, natural gas, and other services and the further recovery of the petroleum industry from the heavy setback suffered in 1958. Better results were also reported by commercial banks and other financial institutions, mining companies, and firms in the amusement and service fields.

In merchandising, earnings were generally lower in both retail and wholesale trade. Food chains as a group managed a small gain, while department and specialty stores just failed to match their year-earlier performance. Declines were recorded for variety chains and for firms in the wholesale and miscellaneous group.

The nation's railroads, whose earnings failed to recover in 1959, experienced another year of falling net incomes as costs continued to mount while traffic declined. Certain Eastern roads were hard hit by strikes.

Intensified competition and narrowing profit margins were the rule in most lines of business. Reductions in list prices and unpublicized discounts were widespread. Because of lower selling prices, a number of companies reported that dollar volumes failed to increase even though unit sales reached new records. At the same time, the more competitive markets required additional sales efforts, especially for the introduction of new products created through long-range research programs. The most common problem for industry, however, was the unremitting pressures exerted by rising employment costs which continue to push higher year after year.

The profit pinch created by rising costs spurred most companies to undertake vigorous campaigns to reduce expenses by cutting inventories, streamlining operations, and increasing efficiency. Administrative expenses were a principal target, and a number of firms regrouped their organiza-

Preliminary Summary of Net Income of Leading Corporations for the Years 1959 and 1960

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Reported Net Income After Taxes 1959	Reported Net Income After Taxes 1960	Per Cent Change
118	Food products	$ 538,192	$ 531,487	— 1
28	Beverages	150,433	138,830	— 8
14	Tobacco products	242,905	254,010	+ 5
47	Textile products	163,552	155,265	— 5
43	Clothing and apparel	39,820	47,423	+19
18	Shoes, leather, etc.	42,385	35,860	—15
22	Tires, rubber products	260,508	233,611	—10
35	Lumber, wood prod.	152,620	121,644	—20
59	Paper and allied prod.	324,766	315,742	— 3
65	Chemical products	1,076,139	1,024,453	— 5
39	Drugs, soap, cosmetics	445,624	467,315	+ 5
12	Paint and varnish	55,783	52,666	— 6
97	Petrol. prod. & ref.	2,628,357	2,840,909	+ 8
58	Cement, glass, stone	444,065	381,915	—14
42	Iron and steel	820,434	795,287	— 3
110	Elec. equip., radio & tv	634,366	563,715	—11
135	Machinery	555,320	427,454	—23
33	Nonferrous metals	401,235	388,039	— 3
294	Other metal products	737,431	667,339	—10
48	Automobiles and parts	1,613,398	1,614,275	+—*
48	Other transp. equip.	175,134	164,793	— 6
114	Misc. manufacturing	183,992	176,860	— 4
1,479	Total manufacturing	11,686,454	11,898,892	— 2
13	Metal mining	35,715	43,619	+22
18	Other mining, quarry.	88,328	89,676	+ 2
31	Total mining, quarry.	124,043	133,295	+ 7
87	Chain stores — food	222,008	229,190	+ 3
41	Chains — variety, etc.	131,915	119,583	— 9
45	Department and spec.	149,725	146,166	— 2
80	Wholesale and misc.	333,708	310,834	— 7
203	Total trade	837,356	805,773	— 4
108	Class I railroads	578,314	469,600	—19
46	Other transportation	105,701	82,059	—22
154	Total transportation	684,015	551,659	—19
151	Elec. power, gas, etc.	1,453,901	1,570,090	+ 8
14	Telephone & telegraph	1,284,459	1,394,972	+ 9
165	Total public utility	2,738,360	2,965,062	+ 8
37	Amusements	29,997	35,252	+18
14	Restaurant and hotel	10,387	10,290	— 1
50	Other bus. ser. & const.	98,997	97,148	— 2
101	Total amuse., ser., etc.	139,381	142,690	+ 2
†	Commercial banks	1,257,000	1,686,000	+34
144	Investment trusts	491,890	543,867	+11
47	Sales finance	229,278	242,323	+ 6
23	Real estate	9,435	6,324	—33
214	Total finance	1,987,603	2,478,514	+25
2,347	Grand total	$18,197,212	$18,475,885	+ 2

*Increases or decreases of under 1% not shown.
†Federal Reserve Board tabulation for all member banks; banks not included in total number of companies.

tions while making deep cuts in management and white-collar personnel. As business slackened in the second half, some firms also trimmed plant and equipment expenditures. On the other hand, research and development activities were generally maintained or stepped up in order to raise efficiency and create marketable products for future sales expansion.

Mixed Trends in Manufacturing

Sharp contrasts in fortune developed during the year in manufacturing. Of the 1,479 companies reporting to date, fewer than half managed to score gains over 1959. After a good first quarter, profit margins tended to shrink in each succeeding quarter with declines showing up in both durable and nondurable goods lines.

For the fourth quarter alone, reports available for 718 companies show a less-than-seasonal upswing of 13 per cent in earnings from the preceding quarter and a rise of 2 per cent from the 1959 final quarter. The increase from last year, however, was mainly attributable to the depressed profit levels in the year-ago quarter caused by the steel strike. In fact, almost three out of every five companies suffered a decline in earnings from the year-ago period.

For most of manufacturing, 1960 reports painted a disappointing picture, brightened in spots by improved results in a few individual industries. The most notable performance was turned in by the petroleum industry as resolute efforts to pare expenses and raise efficiency since the 1958 profit slump continued to bear fruit. Oil earnings were also helped by firmer prices of refined products, and by better sales of petrochemicals and natural gas.

The steel companies, whose earnings had shown little recovery from the 1958 recession because of the strike, experienced another troublesome year. Though the industry produced 6 per cent more steel last year, profits fell slightly from the 1959 level. Three out of four reporting steel makers suffered decreases in net income last year; seven out of the total of 42 firms dipped into red ink. In nonferrous metals, the aluminum industry saw profits shrinking mainly because of weaker prices for fabricated items. Copper producers benefited from firmer prices, relative absence of strikes, and active demand abroad.

In the automobile and parts industry, earnings were virtually unchanged even though the auto makers turned out more cars than in any previous year except 1955. Despite higher sales, the shift toward compact cars narrowed margins. Overall earnings of major aircraft and missile makers continued to shrink, though individual companies bucked the trend with the help of increased military deliveries. Profit totals for the group were pulled down by heavy write-offs for commercial jet airliners by leading plane makers.

Sharp price competition, especially in appliances, led to lower earnings for the electrical equipment, radio, and television group. In the electronics industry, however, a large number of specialized firms continued to show growth in sales and earnings.

In the diversified machinery field, results were mixed but the general trend was downward. Machine tool makers received increased orders from abroad last year, but domestic business remained relatively slack and only a few companies managed to show improvement in earnings. Manu-

facturers of textile machinery, on the other hand, enjoyed one of their better years with a marked upswing in profits reported by leading firms. Makers of farm and construction equipment saw their earnings reduced as heavy inventories forced production cutbacks for farm machinery; the domestic market for construction equipment was sluggish, but brisk demand from abroad bolstered earnings of some producers.

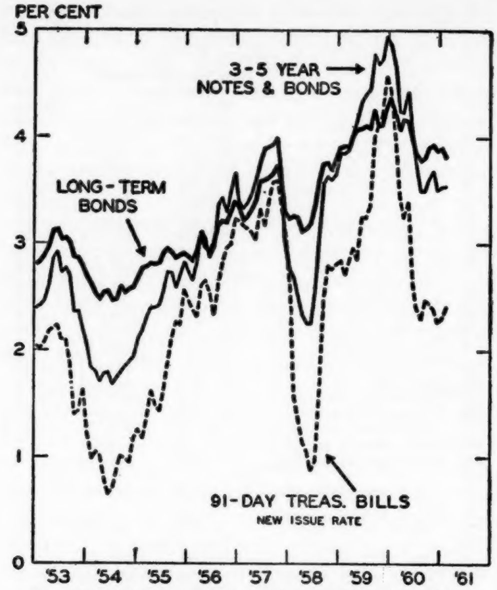
Stiff competition and some weakening of prices affected earnings in the chemical industry as most of the major firms experienced slippage in profits. Price softening also appeared in some pharmaceutical lines, but a number of drug makers managed to score substantial gains in earnings. Soap and cosmetics manufacturers generally had a profitable year.

The drop in new housing starts last year cut a wide swath in sales and earnings of industries producing such materials as lumber, plywood, glass, gypsum, and plumbing supplies. Intense competition in the replacement tire market led to low selling prices and reduced profits in the rubber industry. Rivalry was equally keen among producers of rayon and nylon tire yarns whose earnings also suffered as a result. The textile industry slipped below its 1959 performance, with declines centering among rayon producers and carpet makers. Clothing manufacturers posted better over-all results for the year, but earnings in the shoe industry declined with lower production.

Earnings of food manufacturers slipped only slightly from the preceding year. But the decline was somewhat steeper among beverage firms, partly owing to a cool summer that held down consumption. In the tobacco industry, small declines predominated, but these were offset by the heftier gains made by a few producers.

Nudging the Capital Markets

Among the familiar methods of bolstering business and spending in a slump is increasing the supply and lowering the cost of credit. This method has already been put into effective use. Federal Reserve Bank discount rates were cut as early as last June, before the business recession had taken shape. During the second half of 1960, the Federal Reserve Board reformed the system of cash reserve requirements applicable to their member banks with the effect of adding substantially to bank lending power. By this latter means, as well as through purchases of Treasury bills in the open market, needs of banks to borrow from the Reserve Banks were sharply reduced and excess reserves accumulated. Ever since June 1960, the banks have been in a "free



Market Yields on U.S. Government Securities
Monthly Averages

reserve" position: their excess reserves have exceeded borrowings.

As evidence of the change in the markets for credit, yields on 91-day U.S. Treasury bills (as the chart shows) have fallen from about 4½ per cent in December 1959 to around 2⅜ per cent this February, while yields on three to five-year U.S. Treasury notes and bonds have slid from 5 per cent to just above 3½ per cent. Yields on long U.S. Treasury bonds have declined from 4⅜ per cent to as low as 3¾ per cent. Costs to states and municipalities of raising money through bond sales have fallen nearly ½ per cent and money costs to corporations putting out long-term bonds have retreated more like ¾ per cent. With these declines in bond yields, life insurance companies and other institutional investors are aggressively seeking out mortgages to keep up their investment returns. Rates on mortgages, characteristically more sluggish, have not retreated to the same extent, but the significant thing is that the market, during the past year, has swung from a position of excessive demands for construction money to one of excessive supplies of funds seeking mortgage investment.

As the chart shows, and the table brings out more clearly, the declines in yields on U.S. Government securities are roughly comparable, in percentage points, to those in the two preceding business recessions. At the same time it is to be noted that yield advances in the intervening periods of recovery and prosperity have been greater than declines in recessions. This is an-

other way of saying that interest rates have been undergoing a basic structural adjustment, toward levels demonstrably necessary to sustain savings flow in an age of inflation and heavy taxation of interest income.

Market Yields on U.S. Government Securities During Three Postwar Business Recessions

(Monthly Averages)

	91-day Bills	3-5 yr. Notes & Bonds	Bonds Due After 10 yrs.
June, 1953	2.23%	2.92%	3.13%
June - July, 1954	0.65	1.69	2.47
Oct., 1957	3.59	3.99	3.73
April - June, 1958	0.88	2.25	3.12
Dec. '59 - Jan. '60	4.57	4.95	4.37
Feb., 1961	2.41	3.55	3.81
		Yield Changes	
June '53 - July '54	—1.58%	—1.23%	—0.66%
Oct. '57 - June '58	—2.71	—1.74	—0.61
Dec. '59 - Feb. '61	—2.16	—1.40	—0.56

Yet, in view of the accumulation of $500 million free reserves among the banks, it is surprising that yields on 91-day Treasury bills have not declined closer to the nominal levels of around 1 per cent reached in the 1954 and 1958 recessions. The shortest-term rates are normally the most sensitive to accumulations of excess reserves in the banking system.

Administration's Rate Objectives

The failure of three-month Treasury bill yields to fall further reflects many crosscurrents of supplies and demands. But it also reflects official efforts to manage the money market and protect the short rates from total collapse. President Kennedy dealt with the subject in his February 2 Message on Economic Recovery and Growth. He stressed that long-term interest rates should decline for domestic purposes but that further declines in short-term rates "would lead to a further outflow of funds abroad, adding to the deficit in our balance of payments":

> In these circumstances, monetary policy and debt management must serve two apparently contradictory objectives: checking declines in the short-term rates that directly affect the balance of payments, and increasing the flow of credit into the capital markets at declining long-term rates of interest to promote domestic recovery.
>
> These two objectives can be achieved concurrently, but only with close cooperation among all governmental agencies concerned.

This point of view had been commended to the President in reports of "task forces" headed by Professor Paul A. Samuelson and Mr. Allan Sproul. Both groups urged that monetary and debt management policies be adjusted to the aims of keeping short-term rates up and "nudging" long-term rates lower.

Toward sustaining short-term rates, two influences have been brought to bear. For one thing, the Federal Reserve, in its open market operations for the past several months, has tended to supply bills when market demands were driving yields down toward 2 per cent and, in introducing additional funds into the money market, has relied less exclusively on Treasury bill purchases and has done some buying of short-dated Treasury certificates of indebtedness, notes, and bonds. The Treasury, working toward the same end, has concentrated its own offerings in the short-term area and, since mid-January, has added $500 million to the supply of Treasury bills. The Treasury has foregone any offerings of long-term bonds, due beyond ten years, ever since the advance refunding last fall.

There is a question whether excessive attention is being given to the importance of keeping up short-term money rates. It is true that the gold outflow has slowed in recent weeks. On the other hand, foreign central banks, who alone are licensed to purchase monetary gold from the U.S. stock, are less sensitive to money rates than to the possible risk that radical fiscal programs might lead to dollar devaluation in terms of gold. There is little doubt that the moderation of President Kennedy's federal spending programs, his resolute assurances that the dollar would not be devalued, and his program for dealing with the balance-of-payments problem, have had more to do with the slowing of the gold outflow than anything else.

The policy of sustaining Treasury bill yields has its advantages. Like any other policy of interfering with natural price movements, it also has some unexpected consequences. The biggest holders of bills are corporations, which alternatively keep surplus funds in such short-term paper or in checking account deposits with their banks. When bill yields drop to nominal levels, corporations do not have the incentive to invest the last nickel; they leave more money in demand deposits at their banks, with the effect of enlarging the money supply and, more important, the surplus lending resources among the banks. Understandably, the calculated money supply has risen with conspicuous sluggishness; it is still 2 per cent below the peak recorded back in July 1959. The banks, to get added loan and investment resources, have had to build up interest-bearing deposits. Since these deposits involve substantial expense, bank loan rates have declined less than might otherwise have been the case.

The present relationship between short and long rates has also had some effect of subtracting from the buoyancy which the bond market gets, in a period of easy money, from the in-

ducement to investors to lengthen out their portfolios in quest of livable yields. The differential in favor of Treasury bonds over bills is still 1¼ per cent or better. But the spread exceeded 1¾ per cent in 1954 and reached 2⅜ per cent in 1958.

Helps for Home Building

In his economic message, President Kennedy stated his aim of lowering long-term interest rates to increase the flow of credit for business plant and equipment, for state and local governmental facilities, and for residential construction. At the same time, he announced a small cut in the maximum rate on FHA-insured home mortgage loans from 5¾ to 5½ per cent. He did not mention the Samuelson report's suggestion of a 4½ per cent mortgage rate, something that would simply kill the program by suffocating investor interest. The more modest adjustment, to 5½ per cent, can perhaps be justified on the basis of market conditions; investment interest in home mortgages has been increasing with results of reducing discounts on the previous 5¾ per cent FHA mortgages.

To enlarge the flow of funds available for home mortgages, the Federal National Mortgage Association (FNMA) has raised the price scale at which it will buy FHA mortgages, and the Federal Home Loan Bank Board has announced a series of measures to make it easier for member savings and loan associations to raise money through the Federal Home Loan Banks.

Home building is a huge, $20-billion-a-year industry with an enormous capacity to absorb loan funds since the bulk of money spent on homes is borrowed. In earlier recessions, home building, albeit after a time lag, responded to the ready availability of mortgage credit. But it is now less responsive. There is no backlog any more of housing demand carried over from the Great Depression and World War II. As mentioned in these pages a month ago, the age brackets that provide the greatest demand for new housing are hollow ones because of the low birth rate in the Thirties.

Finally, the industry, taking advantage of bountiful government aids, has gone far to price itself out of the market. Home building could benefit most from actions like that reported in the following Associated Press dispatch:

> LOS ANGELES, Feb. 18 — A Los Angeles local of the International Association of Plasterers and Cement Masons rejected last night a 12½-cent-an-hour wage increase offered by employers.
>
> "We feel our present wages are sufficient," said Burt Chapman, president of Plasterers Local No. 2. "We turned down the extra money in order to support President Kennedy's plea to hold the line on inflation and because it may stimulate construction work."

Modification of Bills Only

A sensitive area for controversy has been opened by the Administration's desires that the Federal Reserve, which has pursued the practice of dealing only in the short-term money market, should deal also in long-term U.S. Government bonds. The idea is that Federal Reserve purchases would raise prices of U.S. bonds and encourage holders to sell out and realize funds which would, it is expected, be shifted into other long-term investments such as mortgages and corporate and municipal bonds.

The most eloquent advocate of such operations is Mr. Allan Sproul, former president of the Federal Reserve Bank of New York and chairman of President Kennedy's task force on "The Economic Situation and the Balance of Payments." Federal Reserve intervention into the long-term market got a bad name from the practice of "pegging" government bond prices at par or better during and after World War II. In 1951, after a period of sharp controversy between the Treasury and the Federal Reserve, the practice was suspended. By 1953 the Federal Reserve had washed its hands of transactions in bonds, permitting forces of supply and demand in the market to suggest the terms upon which the Treasury could sell additional bond issues. Open market operations have been in very short-term securities, preferably bills, where the price impact of purchases and sales is smallest and the securities are most closely analogous to money.

In calling for "modifications" of this technique, the Sproul report took the accepted point of view that "action to provide bank reserves through purchases of short-term securities may magnify declines in money market rates of interest and provide an undesirable incentive for short-term funds to move abroad." Further:

> There are occasions for attempting to exert some influence directly on long-term rates of interest by way of open market operations of the Federal Reserve System.
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> * * * *
>
> Such intervention would not lessen the breadth of the market nor deprive it of its ability to reflect underlying factors of capital demand and savings supply. Neither would it nor should it involve pegging of rates nor attempts to prescribe a whole pattern of rates extending throughout the rate structure. But it would mean nudging a sticky market in the direction indicated by the underlying factors in the market, and thus contribute to the effectiveness of monetary policy.

The Federal Reserve Announcement

The Federal Reserve, beginning late last October, with an eye to avoiding undue decline

in Treasury bill yields, bought small amounts of U.S. bonds, but with maturities no longer than 15 months. On February 20, the Federal went further and announced that:

> The System Open Market Account is purchasing in the open market U.S. Government notes and bonds of varying maturities, some of which will exceed five years.
>
> Price quotations and offerings are being requested of all primary dealers in U.S. Government securities. Determination as to which offerings to purchase is being governed by the prices that appear most advantageous, i.e., the lowest prices. Net amounts of all transactions for System Account will be shown as usual in the condition statements issued every Thursday.
>
> During recent years, transactions for the System Account, except in correction of disorderly markets, have been made in short-term U.S. Government securities. Authority for transactions in securities of longer maturity has been granted by the Open Market Committee of the Federal Reserve System in the light of conditions that have developed in the domestic economy and in the U.S. balance of payments with other countries.

It remains to be seen how far these transactions, and their price effects, will go. Seasoned market observers have expressed doubts that the authorities will find it possible to purchase large amounts of long-term U.S. Treasury bonds around existing price levels. In other words, there may be more price effect than quantity effect. The amount of genuinely long-term U.S. bonds outstanding is not large and most bonds are put away in the box and are not for sale. The price rise — unless countered by new U.S. bond financing or Federal Reserve sales — could run out of hand if every speculator and his brother decided to buy government bonds on small margins for capital gains. At some point, of course, genuine investors would capitalize upon the opportunity to unload bonds, leaving the authorities, perhaps, with an unhappy choice between letting the house of cards collapse or buying more bonds than they want and bailing the speculators out.

But it must be assumed that the authorities are alert to these perils and will limit themselves to occasional small purchases simply to provide a tone of price firmness in the bond market. Following the announcement, initial Open Market Committee purchases, revealed in the Federal Reserve statement for the week ended February 22, were confined to $7 million notes and $6 million bonds in the five- to ten-year maturity area. Price markups ranged from ¼ point on four-year Treasuries to as much as 1¼ points on long-term bonds.

The Federal Reserve announcement made it seem clear that this policy change represented an adjustment to a present, and presumably temporary, situation. Certainly the authorities should not wish to intervene with such frequency as to take on a real or apparent responsibility for all movements in government bond prices and to deny to normal forces of supply and demand their opportunity to be heard. A market shoved up on stilts, as we have learned before, is one that, appealing as it may be to speculators, breeds distrust among investors and preferences for tangible property.

World Shortage of Money?

One hears more and more discussion of the idea that the world is facing a liquidity crisis or, in plainer English, running short of money. President John F. Kennedy, in his February 6 Message on Balance-of-Payments and Gold, took note of these apprehensions and directed that the Secretary of the Treasury promptly initiate studies of measures to improve international monetary institutions:

> Increasing international monetary reserves will be required to support the ever-growing volume of trade, services and capital movements among the countries of the free world. Until now the free nations have relied upon increased gold production and continued growth in holdings of dollars and pounds sterling. In the future, it may not always be desirable or appropriate to rely entirely on these sources.
>
> We must now, in cooperation with other lending countries, begin to consider ways in which international monetary institutions — especially the International Monetary Fund — can be strengthened and more effectively utilized, both in furnishing needed increases in reserves, and in providing the flexibility required to support a healthy and growing world economy.

At the same time, the President observed that the United States has never made use of its rights to draw on the International Monetary Fund (IMF) to meet deficits in its balance of payments and stated that: "If and when appropriate, these rights should and will be exercised within the framework of Fund policies." These drawing rights provide a ready-made device for checking excess dollar accumulations by specific other countries. The United States could draw out of the Fund, in exchange for dollars, the currencies of such countries, for sale in the foreign exchange market. This would be a way of exploiting the new strength of European currencies and economizing on gold reserves. The IMF, thus, would become the holder of the excess dollars for use when nations abroad run short again.

Foreign governments and their central banks, in the aggregate, have gold and dollar reserves

swollen beyond any previous experience — a result of the oversized U.S. balance-of-payments deficits. The recent worry has been that the United States itself would run short of reserves. But there is not yet any critical shortage here. As the President explained, the U.S. gold reserve is more than 1¼ times foreign official dollar holdings, more than 90 per cent of all foreign dollar holdings, and some two fifths of the gold stock of the entire free world. Beyond this, as he pointed out, we have the drawing rights on the IMF of $4.1 billion, debts of strong European countries to the U.S. Government of $2.9 billion, and private short-term assets abroad estimated at $4.5 billion.*

A Plentiful Supply

In short, the world has a plentiful supply of reserves. In time, of course, the shoe may pinch, particularly if the nations indulge inflation as a way of life. But in that eventuality something ought to pinch, to remind governments of their responsibilities to protect the value of money and to awaken business and trade-union leaders to the follies of wage-price spiraling.

Nevertheless, the idea has been bruited about for some years now that governments and central banks as a general matter lack sufficient reserves to tide them over temporary periods of adversity in their balances of payments. The IMF, as the responsible world organization in this area, published a reassuring study of *International Reserves and Liquidity* in August 1958. Despite a subsequent 50 per cent increase in the Fund's resources, and enlarged deficits in the U.S. balance of payments leading to excess dollar accumulations in a number of countries abroad, people keep on saying that the world is headed for a liquidity crisis. To avert this, Professor Robert Triffin of Yale proposes that the 68 members of the IMF should shift more of their gold and all of their exchange reserves into an expanded IMF which would become a super-central bank with powers to issue its own money to be held by member countries as official reserves.

News dispatches report that the question is being discussed actively among Treasury officials and central bankers in Europe as well as in Washington. The Congressional Joint Economic Committee has displayed an eager interest. Heads of at least two leading British banks have expressed themselves favorably.

The International Chamber of Commerce, on the other hand, in a report adopted February 22, expressed confidence in the stability of the U.S. dollar and, while continuing study of the question, went on record against any "far-reaching" revisions in the present monetary system. The Managing Director of the IMF, Dr. Per Jacobsson, writing on November 6, 1959 to Senator Paul Douglas, Chairman of the Joint Economic Committee, stated that he could detect no over-all problem as far as international liquidity is concerned, although some individual countries have still to achieve balance in their international accounts:

> Such balance cannot, in my opinion, be attained or even facilitated by the introduction of any new expedients, but only by the appropriate measures being taken by the countries concerned, together with such international assistance as may be needed in individual cases.

Referring to the super-central bank plan offered by Professor Triffin, Dr. Jacobsson confessed that he personally could not see any value in the scheme and expressed the opinion that it was "impractical" and might even be "positively harmful."

The Triffin Plan

Professor Triffin has a substantial reputation as a student of international finance and has served as financial advisor to a number of Latin American countries and also to the European Payments Union. He regards the Western world as facing an awkward dilemma: if the United States should fail to straighten out its balance of payments, confidence in the dollar would be shattered and a run on gold provoked; if we succeed in balancing our payments, the main source from which the rest of the world has been rebuilding its gold and dollar reserves would be dried up. If the world escapes the Scylla of an American liquidity crisis, it is bound to fall into the Charybdis of an international liquidity crisis.

Professor Triffin has testified before the Joint Economic Committee on two occasions and a year ago published a book fearfully entitled *Gold and the Dollar Crisis*. In testimony before the Joint Economic Committee in December, however, Professor Triffin expressed confidence that the U.S. balance-of-payments problem would be solved and switched emphasis to a coming liquidity crisis for the rest of the world. He would greatly enlarge the functions and the powers of the IMF and make it more definitely a super-central bank.

The IMF we already have was conceived during World War II to provide a flexible new machinery for accommodating international financial settlements. It actually serves as a super-central bank, although it has the structure of a clearing union. Funds contributed by member countries are called "subscriptions" rather than "deposits." In borrowing, a nation puts in more

*For fuller details, see the article on "Our International Balance Sheet" in the December 1960 *Letter*.

of its own currency and takes out other currencies. The IMF lacks formal power to create money but nevertheless has wide latitude to make funds available to its members.

Dr. Oscar Altman, of the IMF, who has written a scholarly critique, has identified Triffin's proposed fund as "XIMF." Its currency, for brevity, we might label X-dollars. These X-dollars would be held only by central banks and used among them in settling balances of international payments. The 68 member nations would be required to put reserve funds on deposit with XIMF. For the United States this would mean turning over gold. For other nations it would mean turning over gold and convertible currencies, principally dollars. Thus short-term liabilities of the United States to foreign governments and central banks would become liabilities to XIMF, subject to gradual repayment. The idea is that the dependence of the world monetary system on the dollar and sterling as reserve currencies would first be reduced and, with the passage of time, eliminated.

The XIMF, thus launched, would proceed to create X-dollars to permit a controlled increase in total currency reserves, perhaps 3 to 5 per cent a year. The XIMF's loans and investments would create income to permit payment of interest on deposits.

Ratios of Reserves to Imports

Professor Triffin rests his arguments that reserves are inadequate on an analysis of percentages of currency reserves to imports. He figures that the proportion of reserves to imports for countries outside the United States and the United Kingdom reached a hundred-year low of 35 per cent in 1957, having been declining "at a rather alarming pace" since the end of 1954. Including the U.S. and the U.K., Professor Triffin states that the ratio in 1957 was at its lowest point since the Twenties, and at only half the level of the late Thirties. Of course, as Triffin observes, the ratio in the Thirties was abnormally high, resulting from widespread devaluations and catastrophic decline in the value of world trade.

It should be noted in passing that one lesson of the Thirties is that higher reserves do not of necessity mean more trade. And one lesson out of the period before World War I is that the world of finance can function efficiently under low ratios of reserves to trade if resistance to inflation is sufficiently strong.

Triffin insists that radical changes which have taken place in the world economy in the past thirty years demand that the ratio of reserves to imports be higher than previously. The opposite conclusion would seem more appropriate. The history of these ratios does not have much real relevance to the present international monetary order. Gold has ceased to circulate as money. Governments and their central banks deal in gold but only the United States does so on a large scale and at firmly posted prices. The twentieth century world, in practical effect, is on a dollar standard much as the nineteenth century world was on a sterling standard.

Furthermore, the IMF, invented at the Bretton Woods conference in 1944, has been set up with huge resources to economize on gold and lend reserves to nations in need of funds to correct imbalances in their international payments.

The idea that world trade depends directly on some aggregate of monetary reserves is of dubious validity. It overlooks the essential fact that the great bulk of trade is financed by reverse trade and capital flows. More trade does not necessarily imply more instability and thus need for more reserves. On the contrary, postwar experience suggests that world trade, having grown by leaps and bounds, is much better balanced today than has been true for a generation. Trade and other current payments are much freer, more orderly, and more multilateral. Removals of exchange controls permit private capital – the reserves of the business community – to do more of a job. In fact, a creditworthy country can carry on balanced trade without any official reserves at all.

Potentials Under the Present IMF

Nothing, of course, will spare nations the trouble of balancing up their international accounts over a period of years. But it is curious that critics of the IMF should be so eager to supplant the institution without first evaluating its full potential for supporting further expansion of world trade. And, if the world is so illiquid, how is it that so small a part of the IMF's assets are being called into use?

The Fund's present resources are impressive. It holds over $10 billion in gold, dollars, and other externally convertible currencies. As the *London Times* comments: "There is much more liquidity available from the IMF as it is now than has ever been utilized."

Granted a ready will of the nations to cooperate, and to keep their fiscal houses in order, the possibilities of accommodating trade growth through the IMF are almost unbounded. The limits on world trade are limits imposed by protectionist measures, failures of competitive power, and localized indulgences of inflation. There is no escape in new international monetary machinery from facts of life.

The curse of the IMF is its complexity, its statutes with a jargon of "drawings" and "currency repurchases" replacing intelligible words like loans, repayments, and deposits. It is a pity that it was made a storehouse not only of key, internationally useful currencies like dollars but also of dozens of minor currencies rarely used for international settlements. The saving grace has been the flexibility of the statutes and the wisdom of the Managing Directors. The IMF has in fact been operated as a super-central bank, primarily in U.S. dollars as the table on drawings in various currencies suggests.

Gross Drawings from the IMF, 1947 - 1960

(In Millions of Dollars)

U.S. dollars	$3,203
Pounds sterling	297
Deutsche mark	116
Guilders	23
French francs	18
Canadian dollars	15
Belgian francs	11
Danish kroner	1
Total	$3,684

Source: International Monetary Fund.

The dollar has been the only important currency convertible over this whole period. As other currencies are made convertible, the horizon widens for drawings of other currencies.

The dream at Bretton Woods was that all currencies would be made freely convertible into one another for current transactions. If this were ever achieved the IMF could never run out of money; it could finance an infinite expansion of trade. This dream has never been realized, but there has been a dramatic broadening of convertibility just within the past two or three years. The IMF can take in dollars, pay out marks, and still have the same total of convertible currency reserves as before.

Only last month, the major European currencies accepted obligations under the IMF's Article VIII, which precludes members subject to its provisions from imposing restrictions on current transactions, except with the prior approval of the Fund. These currencies, along with gold and dollars, may henceforth be used to repay drawings from the IMF.

Professor Triffin commends an XIMF to create money to lend for economic development purposes. The IMF could do this but not without wrecking its solvency. At Bretton Woods the task of financing economic development was entrusted to the IMF's sister organization, the International Bank for Reconstruction and Development, which has extended some $5 billion of loans since its beginning in 1947. Even greater sums for development have been put up by private capital, American and European.

It was and is the IMF's job, not to finance development, but to help nations tide themselves over periods of strain on their balances of payments and to advise them on domestic fiscal and monetary policies to sustain the relative values of their currencies and avoid necessities for exchange and import controls as methods of keeping their international accounts in order.

A New World Money

In the United States there is a natural sympathy for the point of view that there is an international liquidity problem. We heard so much so long about "dollar shortages" abroad. And now the succession of balance-of-payments deficits — acting to enlarge reserves abroad — has led to an important decline in the U.S. gold stock and a worrisome increase in short-term liabilities to foreigners. As President Kennedy has pointed out, "the United States has a strong solvent position" in any reckoning of international assets and liabilities. Nevertheless it is somewhat painful to recognize that there are limits to what we can afford to spend abroad as a nation. The temptation is great to unload our gold and foreign short-term debts onto the shoulders of some kind of XIMF, accepting a point of view expressed in *The Economist* that:

> . . . the long range problem is to take on the uncompleted work of Bretton Woods by altering the dollar exchange standard so that the ability of the United States to follow an independent monetary policy is never again in doubt.

The proposal for a new world money — X-dollars — suggests a further probing among monetary students for ways around recurrent shortages of gold. Professor Triffin's scheme calls to mind J. M. Keynes' proposal in 1943 for a new international money to be named "bancor" and to be issued by an International Clearing Union. Keynes accepted the alternative of the IMF and urged approval of the IMF plan as "the exact opposite of the gold standard." Whatever this was intended to mean, it did appeal to British desires to keep freedom from the discipline of gold.

Under Keynes' plan, gold would have been acceptable in exchange for bancor but bancor would not have been exchangeable for gold. In other words, gold would be drawn away from use of central banks just as, in the United States and elsewhere, it has been drawn away from use by the citizen. Paper credits in bancor would have constituted the means for financial settlements among the nations.

The bank could never go broke because its obligations — bancor — would be inconvertible. Individual countries could have their financial

crises — if the bank saw no other way to get them to face facts and straighten out their finances. But the bank would always be free to create more money at its own discretion. The world's gold — disparaged by Keynes as a "barbarous relic" — would be accumulated and put back in a specially constructed mine.

This always seemed a devious way to cut loose from gold and also wasteful since people could find uses for the metal in protecting themselves from paper money inflation. It is this quality of gold that so far has required some tie of world monies to gold. Some governments have found it necessary, at times, to offer the metal on their free markets, to protect confidence in paper. This is the ultimate need for a national gold stock.

Cutting Loose from Gold

The XIMF would be less neat than Keynes' Clearing Union in cutting loose from gold. Encumbered by a network of gold guarantees, it would offer member nations a right to redeem, in metal, deposits in excess of minimum requirements. But risk of insolvency from this side could be avoided by the expedient of raising to 100 per cent the proportion of official reserves required to be kept on deposit with XIMF. Carried to this logical extreme, the member countries would be required to turn all their gold over to XIMF and be denied rights to hold any at all. The XIMF, with a vast gold hoard as a facade of security, would issue inconvertible paper money, lending it out to member countries on a basis of calculated need and with special attention to underdeveloped countries. The only way a member nation could keep a gold reserve would be to sell it out of official reserves into the hands of its own citizens.

With gold gone as a limit upon currency issues, the value of money would come to depend upon the will of the XIMF's management. In the judicious exercise of their powers they would need to pass judgment on spending and borrowing decisions of governments the world over. Whether proud nations would ever consent to such an unprecedented concentration of money power seems dubious.

In any case it is the United States, architect and financier of postwar reconstruction, which has the most at stake. Adoption of XIMF would seem a confession of inability to keep a dollar that people can trust, the world over, as a standard of value.

Yet any XIMF, and its X-dollars, still would have to rest on the integrity of American fiscal and monetary policies. As the distinguished scholar, Dr. Alexander Sachs, comments: "The Triffin Plan is a venture to establish an Esperanto currency. It will no more succeed than efforts of the past half century to spread an Esperanto language. Only a living language can become an international language. Only a successful mighty currency can be an international currency."

One of the allures of the XIMF is that it would offer to pay interest on deposits protected with gold guarantees. But gold is a sterile asset. To rely on a gold clause is to take a credit risk for there is no such thing as interest-bearing gold. Thus, anyone who would believe that the elaborate system of gold guarantees embraced in the XIMF could have tangible meaning over an indefinite future would only be practicing self-deception.

An International Conference?

Voices are heard commending the idea of an international conference to deal with all these questions. The vital thing, initially, is to obtain broad areas of common understanding among the nations which embrace the main money markets of the world. The proposed Organization for Economic Cooperation and Development (OECD), now before the Senate for ratification, could provide a useful forum for this purpose. It will include, besides the old 18-nation OEEC group, the United States and Canada.

The most sensitive question is the relationship of the U.S. dollar to the precious metals. There are many ambiguities to be cleared up, including the one of definition: are we on a gold standard or not? Should the free markets in precious metals be suppressed or liberalized?

U.S. Treasury policy puts us on a limited gold bullion standard. On the other hand, we may read in the April 1960 *Business Review* of the Federal Reserve Bank of Philadelphia that: "By Executive Proclamation on March 4, 1933, the United States officially left the international gold standard." In the same *Review* we are reminded that "society will not permit gold movements to dictate domestic economic policy." Yet gold today is in fact influencing domestic economic policy, advising against fiscal extravagance and excesses of cheap money to get us out of a slump.

Certainly, as William Jennings Bryan prematurely advised, back in 1896, we must not "crucify mankind upon a cross of gold." But of this there seems to be little present danger. What the gold outflow has done is communicate a sense of hard reality to the need to keep our house in order. It is easier to accept this warning from an impersonal metal than from a council of financial dictators gathered in an XIMF.

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